78-SBE-038

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
LOS ANGELES AREA DODGE)
DEALERS ASSOCIATION)

Appearances:

For Appellant: James G. Lewis
Attorney at Law

For Respondent: David M. Hinman
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Los Angeles Area Dodge Dealers Association against a proposed assessment of additional franchise tax in the amount of $625.41 for the income year ended October 31, 1973,

The issues for determination are: whether appellant, a mutual association, may deduct from its gross income interest earned on short-term certificates of deposit: or, in the alternative, whether appellant's advertising and operating expenses are deductible from its investment income.

Appellant is a mutual association within the meaning of section 24405 of the Revenue and Taxation Code. Section 24405 [1/] allows mutual associations a deduction for all income resulting from or arising out of business activities for or with members, or with nonmembers when done on a nonprofit basis.

Appellant's purpose is to provide advertising for dealer-members. Appellant is funded by the Chrysler Corporation, which assesses each dealer-member $30 for each car or truck shipped to it. These funds are forwarded to appellant to be used for advertising and sales promotion. Funds which are not immediately needed for advertising expenses are placed in short-term interest bearing certificates of deposit. For the year in issue appellant deducted the interest earned on the certificates on the basis that it was income arising out of business carried on for its members and deductible pursuant to section 24405. Respondent audited appellant's franchise tax return and determined that the interest income did not qualify for a deduction under section 24405. Appellant appeals from the resulting proposed assessment.

1/ Section 24401 states that in addition to the deductions provided in article 1, "there shall be allowed as deductions in computing taxable income the items specified in this article." Section 24405, which is part of the appropriate article, provides, in part:

> In the case of other associations organized and operated in whole or in part on a cooperative or mutual basis, all income resulting from or arising out of business activities for or with their members carried on by them or their agents; or when done on a nonprofit basis for or with nonmembers ....

Initially, appellant argues that the interest earned on members' contributions is indirectly attributable to membership assessments and is, therefore, income arising out of business activities carried on for members, which is deductible pursuant to section 24405.

On several previous occasions we have held that interest earned on investments of the same or similar type as those involved here was taxable. Those appeals have all held that such income was not deductible under section 24405 as income from business activities "for or with" members. (Appeal of Woodland Production Credit Assn., Cal. St. Bd. of Equal., Feb. 19, 1958; Appeal of Credit Union, California Teachers Assn., Cal. St. Bd. of Equal., July 19, 1961; Appeal of California State Employees Credit Union No. 1, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Southern California Central Credit Union, Cal. St. Bd. of Equal., Feb. 3, 1965.)

The same result was reached in Woodland Production Credit Assn. v. Franchise Tax Board, 225 Cal. App. 2d 293 [37 Cal. Rptr. 231] (1964). In Woodland, a cooperative engaged in making loans to its members received interest from investments in United States bonds. Reasoning that section 24405 was intended to exclude from tax the savings or price adjustments produced by a cooperative in carrying out the purposes for its existence, the court concluded that the statutory phrase "business activities" applies only to a cooperative's transactions with or as agent for its patrons, who may be either "members" or "nonmembers". The court held that the investment of reserves or surplus in interest-bearing securities is not a business activity "for or with" its members within the ambit of section 24405; therefore, the interest income was not deductible.

Appellant argues, in the alternative, that even if the interest income is not deductible from gross income, it should be entitled to deduct its advertising and other operating expenses from the interest income. In opposing appellant's position, respondent relies on Anaheim Union Water Co. v. Franchise Tax Board, 26 Cal. App. 3d 95 [102 Cal. Rptr. 692] (1972), where the court considered and rejected an argument substantially the same as the one advanced by appellant.

Anaheim involved a section 24405 mutual water company which attempted to deduct expenses attributable to producing nonincludible income from other includible income. The resolution of the question was controlled

by section 24425 of the Revenue and Taxation Code. Section 24425 provides that no deduction shall be allowed for any otherwise deductible amount "which is allocable to one or more classes of income not included in the measure of the tax imposed by this part." Noting that statutes must be construed in a reasonable and common sense manner, not in a manner that would lead to absurd consequences, the court rejected the taxpayer's argument, and held that to permit a mutual association to deduct expenses incurred in connection with nonincludible business activity from profit-making activities was neither reasonable nor logical.

In seeking to avoid the thrust of Anaheim, appellant argues that all of its revenues are from member assessments, and that no expense is incurred in producing this nonincludible income. While Substantially all of its revenue is used to obtain advertising for its members, appellant continues, none of this expense is allocable to the production of nonincludible income. Appellant concludes, therefore, that it is entitled to deduct its member contributions pursuant to section 24405, and also that it is not prohibited by section 24425 from deducting the expenses incurred in carrying out its purpose.

We believe appellant's interpretation of Anaheim and the corresponding construction of section 24425 is too restrictive. Section 24425, relied on by the court in Anaheim, prohibits the deduction of any expense that is allocable to income not includible in the measure of tax. The purpose of this section isto prevent a double deduction. (See Anaheim Union Water CO. v. Franchise Tax Board, supra, 26 Cal. App. 3d at 104.) Statutes must be given a reasonable and common sense construction in accordance with their purpose, a construction that is practical rather than technical and one that will not lead to absurdity. (See Anaheim Union Water Co. v. Franchise Tax Board, supra, 26 Cal. App. 3d at 105.) It is true, as appellant asserts, that all of the advertising and other operating expenses were not incurred in order to generate the nonincludible member contributions. However, we believe that the expenses were, nevertheless, allocable to such income in the sense that they were connected with, or associated with, that income. Surely, it cannot be argued that those expenses were allocable to the interest income which was includible in the measure of tax. To accept appellant's argument would allow it, initially, to deduct its member contributions and then to deduct the same amounts a second time when they are expended to acquire advertising services

for the members. Such a position is unreasonable and would violate the very purpose and policy behind section 24425. Accordingly, appellant's argument must be rejected.

For the reasons set out above, we conclude that appellant may not deduct from its gross income interest earned on short-term certificates of deposit, and that appellant's advertising and operating expenses are not deductible from its investment income.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Los Angeles Area Dodge Dealers Association against a proposed assessment of additional franchise tax in the amount of $625.41 for the income year ended October 31, 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June, 1978, by the State Board of Equalization.

_______________, Chairman

_______________, Member

_______________, Member

_______________, Member

_______________, Member